

## COMMENT LETTER

February 11, 2000

# Comment Letter on NASD Proposal for Corporate Bond Facility, February 2000

February 8, 2000

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: NASD Proposal Relating to the Creation of a Corporate Bond Trade Reporting and Transaction Dissemination Facility  
(File No. SR—NASD 99-65)

Dear Mr. Katz:

The Investment Company Institute<sup>1</sup> appreciates the opportunity to present its views on the proposal by the National Association of Securities Dealers, Inc. ("NASD") to establish a corporate bond trade reporting and transaction dissemination facility.<sup>2</sup> The Institute supports the NASD's proposal.

Under the proposal, NASD members would be required to report to Nasdaq's Trade Reporting and Comparison Entry Service ("TRACE") all secondary transactions in specified U.S. corporate bonds within one hour of trade execution.<sup>3</sup> The Release states that after an initial six-month period for information integrity review, Nasdaq will disseminate trade reports to the public through market data vendors and the initial one-hour maximum trade reporting time frame will subsequently be reduced to fifteen minutes. Furthermore, as part of this initiative, and simultaneous with the effectiveness of the new rules, NASD will eliminate Nasdaq's Fixed Income Pricing System ("FIPS") and its related rules and costs.<sup>4</sup>

Investment companies, on behalf of millions of retail investors, are significant investors in corporate debt securities. As such, investment companies can benefit greatly from improved price transparency in the debt markets. The NASD's proposed trade reporting and transaction dissemination facility would provide accurate and timely information to the marketplace, and represents a significant step towards achieving price transparency in the corporate bond market, an initiative that was fostered by the Commission.<sup>5</sup> In addition, the NASD's proposal should enhance significantly regulatory oversight of the corporate bond market. This in turn should help to ensure the integrity of this market, thus benefiting

investment companies and their shareholders.

The Institute's specific comments on the NASD's proposal are set forth below.

## **The TRACE Service**

**Dissemination of Market Data.** Under the NASD's proposal, NASD members would submit trade reports to TRACE, which would then disseminate certain transaction information to the public via market data vendors. The Institute agrees that TRACE should be the central repository for corporate bond transaction information, which will allow for the necessary surveillance of the market. We do not believe, however, that TRACE should be the only vehicle through which this trade data is disseminated. Rather, private initiatives to capture and distribute trade data should be able to develop freely in the marketplace. Market participants would benefit greatly from a competitive process for the collection and dissemination of trade data that is widely available in machine-readable form. We are pleased that the NASD's proposal would not preclude the development of such other initiatives.

Under the NASD's proposal, transaction reporting in corporate bonds would be phased in over a six-month period in order for the NASD to conduct an information integrity review. We support this approach and believe that it may be advisable for transaction dissemination to also be phased in. Phasing in the implementation of TRACE would enable the NASD and market participants to evaluate the success of the facility, particularly whether more, less or different information should be disseminated.

**Fees.** Several of our members have expressed concern about the possibility of the NASD's charging excessive fees for the data it will collect and sell back to the market as a result of the market dominance TRACE will likely enjoy, at least until other methods to facilitate the flow of trade data are developed, and in view of Nasdaq's intention to become a for-profit enterprise. We note that the Commission has issued a concept release on market data fees and revenues.<sup>6</sup> In that release, the Commission expressed the view that fees charged by a "monopolistic" provider should be tied to some type of cost-based standard in order to preclude excessive profits. We urge the Commission to expressly include market data fees collected by TRACE in any future rulemaking in this area or, if TRACE is approved prior to such rulemaking, that the Commission follow some type of cost-based standard in evaluating and approving the fees for TRACE data.

**Impact on Market Liquidity.** The Institute believes that the significant benefits of increased transparency that TRACE would provide to investors in corporate bonds, especially those invested in high yield bonds where price transparency would be most valuable, outweigh any speculative concerns that have been expressed about the potential adverse impact real-time price reporting could have on liquidity.<sup>7</sup> Therefore, we recommend that the NASD not limit the number or scope of the bonds that will be reported to TRACE in response to such concerns.

## **Elements of the Trade Report**

The NASD proposal would require that trade reports submitted by NASD member firms contain certain transaction information.<sup>8</sup> We support this requirement. The NASD's proposal also sets forth certain types of information that would be included in the reports it would disseminate to the market.<sup>9</sup> The Institute likewise supports the NASD's proposal in

this regard, particularly its inclusion of the time the trade is executed. Accurate reporting of the time a trade is executed is critical to determining the relative value of a bond and will be critical for the continued reliability of the prices. Incorrectly reporting the trade time by as little as one to five minutes, particularly in volatile markets, will reduce the utility of the price disclosure to most investors. We are also pleased that the NASD will not disclose the identity of the trading firm involved in the transaction. Indeed, disclosing a trading firm's identity, particularly during a sequence of related trades, could adversely affect the prices the firm is able to receive, thus harming the funds and other clients on whose behalf the firm is trading.

As noted, the NASD proposes to disseminate to the market yield information. That term, however, is not defined in the Release, nor is any guidance provided as to how it will be calculated. The Release notes that TRACE will utilize the price information submitted to calculate bond yield, which would then be disseminated to the public. While we do not object to this procedure, particularly inasmuch as yield would be calculated in a uniform manner, we believe that the method for calculating yield that the NASD will use is sufficiently important that it should be included in the final rule.

The NASD also proposes to disseminate to the market trade report information regarding the actual quantity of bonds traded, except that high yield and unrated trades over a \$1 million par value would be disseminated as "1MM+" and investment grade trades over a \$5 million par value would be disseminated as "5MM+". We recommend that the threshold for high yield and unrated trades be increased to \$5 million. Transactions in those bonds routinely exceed \$5 million. Trades below \$5 million are generally viewed as odd-lot trades and, therefore, may not reflect the price at which larger trades may be executed. Thus, a \$1 million threshold would not provide the market with as much relevant and useful information as would be provided by a higher threshold.

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We appreciate the Commission's consideration of our comments on the NASD's TRACE proposal. If you have any questions, please call the undersigned at (202) 326-5824 or Barry E. Simmons at (202) 326-5923.

Sincerely,

Amy B.R. Lancellotta  
Senior Counsel

cc: Justin J. Tubiolo  
Vice President Fixed Income Securities  
The Nasdaq Stock Market, Inc.

Annette Nazareth  
Director Division of Market Regulation

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Division of Investment Management  
U.S. Securities and Exchange Commission

#### **ENDNOTES**

1 Investment Company Institute ("Institute") is the national association of the American

investment company industry. Its membership includes 8,018 open-end investment companies ("mutual funds"), 495 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.802 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

2 SEC Release No. 34-42201 (Dec. 3, 1999); 64 FR 69305 (Dec. 10, 1999) (the "Release").

3 Corporate bonds subject to mandatory reporting include: (1) U.S. dollar-denominated debt securities issued by U.S. and private foreign corporations that are registered with the Securities and Exchange Commission ("SEC") and eligible for book-entry services at the Depository Trust Company ("DTC"); (2) Rule 144A U.S. high yield debt securities designated as "PORTAL Debt Securities" in Nasdaq's PORTAL Market; and (3) Rule 144A investment grade debt securities eligible for book-entry services at DTC. The Release clarifies that these securities include:

(1) investment grade corporate debt; (2) high-yield and unrated debt issued by U.S. companies and foreign private companies; (3) medium-term notes; (4) convertible bonds; and (5) capital trust securities, floating rate notes, and global bonds issued by U.S. companies and foreign private companies.

4 FIPS requires NASD members to report transactions in 50 of the most liquid high yield bonds traded over-the-counter to the NASD, known as the "FIPS 50," within five minutes of trade execution. All other transactions in FIPS-reportable corporate high yield bonds must be reported by 5:00 p.m. each trading day. See Release at 69310.

5 As a result of SEC staff review of the debt securities market, which found price transparency deficiencies in the corporate bond market, Chairman Levitt, in a letter to Congress, wrote that the Commission had requested the NASD to: (1) adopt rules requiring dealers to report all transactions in U.S. corporate bonds and preferred stocks to the NASD and to develop systems to receive and redistribute transaction prices on an immediate basis; (2) create a database of transactions in corporate bonds and preferred stocks to enable regulators to take a proactive role in supervising the corporate debt market; and (3) create a surveillance program, in conjunction with the development of a database, to better detect fraud and foster investor confidence in the fairness of the corporate debt market. Letter to The Honorable John D. Dingell, Ranking Minority Member, Commerce Committee, U.S. House of Representatives, from Arthur Levitt, Chairman, SEC, dated, September 28, 1998; see also, Testimony of Arthur Levitt, Chairman, SEC, Concerning Transparency in the U.S. Debt Market and Mutual Fund Fees and Expenses, before the Subcommittee on Finance and Hazardous Materials, U.S. House of Representatives, dated, September 29, 1998 (commenting on the importance of transparency in the U.S. debt market).

6 See Securities Exchange Act Release No. 42208 (Dec. 9, 1999), 64 Fed. Reg. 70613 (Dec. 17, 1999).

7 See Statement of William H. James, Chairman of the Corporate Bond Division Steering Committee, The Bond Market Association, before the House Committee on Commerce Subcommittee on Finance and Hazardous Materials, dated September 29, 1998 (commenting on issues related to price transparency in the bond markets).

8 Specifically, each corporate bond trade report would include: (1) buy/sell/cross; (2) CUSIP number or NASD symbol; (3) quantity; (4) price (inclusive of mark-up, mark-down and stated commission); (5) contra-party's NASD symbol or "C" for customer; (6) date and time

of trade execution; and (7) capacity (principal, agent or agency cross).

9 Those reports would reflect: (1) NASD symbol; (2) CUSIP; (3) date/time of execution of trade; (4) price; (5) yield; and (6) actual quantity of bonds traded, via a two-tiered approach.

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